

ORIENTAL ECONOMIST

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Testimony of
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Overview

A decade ago, many US policymakers felt Japan was an economic threat because it was too strong. Since then, we have learned that Japan is more of a problem when it is too weak. Consider the 1997-98 financial meltdown in Asia. Certainly, Japan's economic weakness was not the primary cause of that crisis. However, its weakness did make the crisis somewhat worse than it otherwise would have been (i.e. it imported less than a strong Japan might have; its banks withdrew more from the region than might have been the case without a banking crisis in Japan.)

With this as a background, the Bush Administration came to power wanting to help Japan make itself economically stronger. Then-NSC head Condoleezza Rice told a staffer that she wanted him to focus on Japan's banking crisis because, without solving the banking crisis, Japan could not become healthy. And, in her view, an economically vibrant Japan was needed as a counterweight to a rising China in order to help China peacefully integrate into the community of nations.

In the post-9/11 world, America's economic concerns with Japan have been put on the backburner, as security issues come to the fore. Partly this is because Japan no longer seems as fragile; partly this is because of current primacy of security concerns in Asia.

In this atmosphere, we should not lose sight of several economic developments in Japan that, while not making page one headlines, will play an important role in the geo-economics and geopolitics of Asia in the coming years. In our view, the following developments are the ones for US policymakers to monitor in the coming years:

- 1) Japan has regained a great deal of financial stability. To the extent that there was ever a risk of financial meltdown in Japan—either through a banking crisis or a government bond crisis—that risk is significantly reduced.
- 2) Nonetheless, Japan remains economically weak. While it has probably escaped the zero growth syndrome that afflicted it in 1997-early 2002, its growth going forward will

probably be no more than 1.3%-1.6% over the next five years. It will not be able to play much of a locomotive role either globally or in Asia.

- 3) Japan lags behind other countries, notably China, in the webs of trade and direct investment and formal trade agreements that are creating an increasingly integrated Asian economy. Japan is not in position to play the role of economic counterweight to a rising China.
- 4) US-Japan trade frictions will not be a big issue in the coming years. To be sure, from time to time, there will be important sectoral disputes, e.g. steel or beef, that draw a lot of attention. But the kind of across-the-board tension seen up through the mid-1990s will not likely return. Unless Japan returns to the massive currency intervention seen in 2003 and early 2004, currency disputes will not loom large either.
- 5) There has been a tremendous improvement in the ability of foreign firms, including US firms, to operate in Japan. Foreign Direct Investment (FDI) has increased sharply, but that is still from a very low level.

Financial Stability

The most immediate threat to Japan was its long-lasting banking crisis. In the last few years, that threat has been greatly reduced. Banks have reduced their official level of nonperforming loans to 5.2% of all loans. The major banks are well on their way to meeting the government's goal of reducing the NPL ratio to around 4% by March 2005 (see charts on pg. 8)

Unquestionably, an NPL ratio of 4% is a lot safer than the 10% ratio seen back in 2002. In another good sign, there is finally less new bad debt being generated than the amount of old bad debt being written off.

We would add some caveats, however. There are still some questions about the reliability of the Japanese government's data. Nonetheless, even skeptics agree that the trend has moved significantly in the right direction.

Japan still lags behind standards elsewhere, such as the US. Among US banks, NPLs are only 1.4% of all loans. Moreover, the US Federal Reserve slaps the "delinquent" label on a loan delinquent if interest payments are merely 30 days overdue. The FSA does not call a loan nonperforming until it is three months overdue.

Also, keep in mind that, in Japan, bank loans are still 80% of GDP, compared to about 40% in the US. Consequently, Japan's NPLs today still amount to 4.6% of Japan's GDP—eight times the 0.6% NPL/GDP ratio in the US.

Moreover, a significant part of the debt write-off occurred due to debt forgiveness and debt-for-equity swaps. Not all of the borrowers given such relief are in any better position to avoid new bad debts in the future.

There are a couple indications of this. Despite the improvement in corporate profits and the economy in general, too many firms are being kept alive by incredible low interest rates. As of November 2004, 5.7% of all bank loans charged less than 0.25%—barely enough to pay the light bill or the clerks who count the money. 10.5% of all bank loans charged less than 0.5%, up from 9.7% a year earlier. 23.5% charged less than 1%, up from 22% a year earlier. 37.6% charged an interest rate below 1.5%, up from 35% a year earlier. 59% of all loans charged interest of less than 2%, up from 56% a year earlier (see figure on pg. 9).

According to calculations we made based on data from Ned Akov of Macquarie Securities, marginal firms—those unable to afford a 2% hike in interest rates—still hold a huge

18% of total company debt. While that's a lot better than the 43% figure in March 2002, 18% is still a very high figure (see figure on pg. 9).

Naturally, the picture is markedly better at the listed corporations, where profits have increased more and where some firms have enjoyed debt forgiveness.

So, the financial picture is more stable, i.e. less susceptible to crisis. The banks are in better shape; many of the borrowers are not.

Recent Developments

Japan just went through what some observers call a "technical recession" and others call "an extended pause." Whatever you choose to call it, the fact remains that, in 2004 Japan's GDP declined mildly for two quarters in a row (April-June and July-September), and barely grew in October –December.

The big question is what comes next—both in the short-term and the long-term. On this issue, the level of uncertainty is quite large. Many analysts believe the economy will resume its expansion in the first or second quarter of 2005; others believe it will take longer.

Consequently, the range of growth forecasts for fiscal 2005 (from April 2005 through March 2006) is unusually large. The NLI Research Institute predicts only 0.3% growth, whereas the Norinchukin Research Institute and BNP Paribas believe growth will hit 2%. In the middle are the Daiwa Institute of Research (0.6%), the Mitsubishi Research Institute and Nomura Securities Financial & Economic Research Center (1.1%), and Credit Suisse First Boston and Mizuho Securities (1.5%).

Beyond that, the pause has more or less ended the ebullience that led some forecasters to see 3-4% annual growth for several years to come. Now medium-term forecasts are in the range of 1-2% or, in some cases, 2%+.

Mid-Term Prognosis: 1.3% to 1.6% Growth

Because of the reduced financial instability, Japan is unlikely to have a repeat of the financial turbulence that created five years of slightly negative growth from January-March 1997 through January-March 2002. The bad news is that, for the next several years, Japan is probably going back to nothing more than the mediocre growth seen in 1991-1996.

We believe that Japan's "potential GDP growth," i.e. the rate of growth it could sustain over the medium to long-term if it operated at full-employment/full-capacity, is still around 1.5%. The reason is this: GDP growth is sum of growth in the labor force plus growth in GDP per worker (i.e. productivity growth). Trend labor productivity growth is still around 1.5% a year or so, and the working age population is starting to decline.

This is a fairly conventional estimate. The OECD puts the figure at 1.3%. Japan's Cabinet Office predicts that Japan's growth through 2012 will be around 1.6%.

We believe that, with enough reform, Japan could do much better. For example one economist has calculated that, if Japan took 20 years to get up to US standards of productivity, that alone would add an additional 1.5% a year to existing levels of growth. Hence, in a reformed Japan, growth should be closer to 3% than 1.5%.

There has been a lot of reform already. And more is coming down the pike. Nonetheless,

reform still lacks both the critical mass and the gestation time necessary to create a significant upward shift in potential growth. Firms, for example, are financially stable, but are still plagued by widespread inefficiency. Particularly at the small and medium sized firms that produce the lion's share of Japanese GDP, much of the recent increase in profits has come, not from genuine increases in efficiency, but from cuts in wages. For example, full-time workers who get health and pension benefits are being replaced with part-timers who don't get these benefits.

There is the danger that policymakers in government and business will regard 1.5% or so as "enough." They may prefer mediocre growth as preferable to the political and economic shakeups engendered by serious reform.

In the long run, we don't believe low growth is politically stable. The aging problem alone requires better growth and better productivity. With the ratio of workers to retirees falling from 5 workers per retiree to only 2, unless each worker can start producing a lot more GDP, and unless returns on assets start improving, it will be very hard to support the growing ranks of the elderly. A generational crisis is incompatible with political stability. Nonetheless, in the short to medium run, "reform fatigue" is a genuine danger at the government level and at the firm level.

Recent growth trends

Let us consider recent growth trends in this context. Prior to 2004, the year 2000 was the only year since 1997 in which growth was higher than 1.5%. As a result, Japan entered the current recovery with actual GDP far below its full potential. To get back to full capacity, Japan needs to have several years of growth above 1.5%. Yet, it is so far finding sustained growth above 1.5% hard to come by (see chart on pg. 10).

One reason is that the recovery of the past couple years has been inordinately dependent on two sources: exports and business investment. During the period of fastest growth--the four quarters ending in January-March 2004--exports provided almost half (43%) of all GDP *growth* even though they amount to only 13% of GDP. *Net* exports (i.e. exports minus imports) provided almost a third (28%) of all *growth* even though they amount to only 3% of GDP. Much of that was due to exports to China, as Japan supplied parts and machinery that helped feed China's own export boom. In the four quarters ending in January-March 2004, capital investment provided almost a third (30%) of GDP growth. This, too, is a disproportionate contribution, considering that investment is only 16% of total GDP.

Due to pressure on wage income, personal consumption has been a laggard throughout this recovery. Even though consumption equals about 55% of GDP, it provided only 25% of growth during the four quarters ending in January-March 2004. And in parts of 2004, year-on-year growth in consumption turned negative.

With the economy so precariously dependent on exports and business investment, any faltering of those two sources of demand brings growth to a halt. That is what happened in 2004.

Japan Falling Behind China in Asian Trade

A few years back, some people in Tokyo spoke of Japan becoming the hub of Asian economic integration. Nothing could be further from the truth. Japan is falling far behind China in many of the key trends: trade, trade agreements, and foreign direct investment (FDI).

In many countries, China is already a bigger customer than is Japan. This is particularly true for imports from the Newly Industrializing Economies (see chart on pg. 11). Partly this is due to Japan's slow growth compared to China. Partly this is because Japan still imports comparatively little (relative to GDP), whereas China is a big importer. Beyond that, while Japan's imports have increased substantially in recent years, the lion's share of the increase is from Japanese companies' own overseas affiliates (e.g. importing back to Japan Matsushita TVs made in Malaysia), rather than from indigenous Asian firms.

Japan is also falling behind when it comes to the FDI surge in Asia. In early 2004, Korea overtook Japan passed Japan to become the second biggest investor in China after Hong Kong. According to a report by Credit Lyonnais Securities Asia (CLSA), Korea accounted for 16% of all Foreign Direct Investment (FDI) into China. That puts it ahead of Japan (13%), the US (11%) and Taiwan (9%). If current trends continue, the gap between Korean and Japanese FDI into China will grow further.

While Japan remains Korea's biggest supplier, China is rapidly catching up and may soon overtake Japan.

To the extent that political trends follow economic interdependence, these economic patterns are important to monitor.

US-Japan bilateral trade issues

Except for occasional sectoral disputes, e.g. steel and beef, a blow-up in bilateral US-Japan trade tensions is unlikely in the next few years. The primary reasons are that 1) Japan is no longer seen as a "threat" to major US industries as it was a decade ago; 2) Japan's share of the US trade deficit and of US imports are both rapidly shrinking.

While the trade deficit with Japan has been increasing, this is primarily a *reflection* of the growing global US deficit rather than a *driver* of it. The same, by the way, is also true of China to a large degree.

Japan's share of the US merchandise trade deficit has fallen from a peak of 65% back in 1991 to only 10% as of early 2005. Japan's share of US goods imports has fallen from a peak of 22% back in 1986 to 8% as of early 2005. Meanwhile, China has surpassed Japan both in terms of the bilateral trade deficit and in imports (see charts on pg. 12). Interestingly, while the deficit with China has been growing, the overall US deficit has been growing so fast that China's share of the total US trade deficit is no higher today than it was back in 1997.

US exports to Japan are also sinking, but that is not currently a trade issue because most US firms apparently believe that, even with greater propensity to import by Japan, the anemic economy makes sales an uphill climb. Meanwhile, US exports to China are growing and, if present trends continue, US exports to China will exceed exports to Japan in the not-too-distant future (see chart on pg. 13).

Currency issues

There are many prevalent myths about the dollar's foreign exchange value and the role of Asian central banks. One of these myths is that massive intervention by Asian central banks—particularly those of Japan and China—is the prime reason for the dollar's "high" value. Were

these central banks to stop buying, it is said, the dollar might crash.

First of all, the vast majority—about 75%—of purchases of securities are done by private foreign investors, not central banks. All of the central banks in the world—not just those of Asia—account for only a quarter of net purchases of US securities (see chart on pg. 14).

Secondly, Japan and China account for a minority of foreign purchases of US assets. In the second half of 2004, China (public and private sources combined) has accounted for only 7% of net capital inflow to the US, while Japan has accounted for 23%. On a gross basis (i.e. counting only foreign flows to the US and not vice versa), Japan provides only 6% of the capital (see chart on pg. 15).

As to what would happen if Asian central banks stopped buying, we have already run this experiment. Japan's central bank did intervene on an absolutely monumental basis during much of 2003 and early 2004. But it has not intervened at all since last April and yet the currency markets have barely hiccuped.

There are those who worry that Japan and China own so much of US Treasury debt that they could hold the US hostage. In other words, they could threaten to sell these assets, thereby supposedly creating turmoil in US financial markets, including US interest rates. This is an exaggerated fear. First of all, when the Bank of China and Bank of Japan buy dollar assets, they do so, not as a favor to the US, but to protect their own exports. Selling the dollar would be shooting themselves in the foot.

Secondly, the Japanese/Chinese share of US market debt is too small to create that sort of turmoil. Japan and China together hold about half of the *foreign-owned* portion of Treasury bonds. But altogether, foreigners own only 20% of Treasury debt, so the Japanese-Chinese share is only 10%. More importantly, US interest rates are determined, not simply by Treasury debt, but by demand and supply for all marketable debt. Almost all foreign purchases of US debt involve Treasury debt. But the latter is only about 30% of all marketable debt in the US. That means that the foreign ownership of all US government and private debt is only about 5-6% of the total (see bottom figure). Consequently, even if Japan and China substantially reduced their purchases of US Treasury debt, the effect on US interest rates would be well within the powers of the US Federal Reserve to manage (see chart on pg. 15).

Foreign Direct Investment

After years of resistance to foreign direct investment (FDI), Japan finally began to reverse itself in the last few years. Previously, FDI was seen as a threat to the autonomy of Japanese firms and to the emphasis on "stakeholders" rather than shareholders. But, due to the economic crisis, FDI began to be seen as a source of jobs, as a way to rescue troubled firms (like Nissan), and as a way to pressure Japanese firms to make necessary reforms.

Officials at METI began to work with US officials, particularly the State Department, to find ways to encourage more FDI into Japan. In 2003, Prime Minister Junichiro Koizumi declared a goal of doubling FDI into Japan by 2008. Any doubling would be welcome, but it comes from a very small base.

Finance Ministry data shows a hefty increase in both the annual flow and the cumulative stock of FDI (see chart on pg. 16), but OECD data shows a somewhat different picture. A few spectacular takeovers, e.g. Renault's takeover of Nissan and Ripplewood's takeover of Long-Term Credit Bank (now Shinsei), have created headlines and raised the aggregate numbers. We

believe the trend is positive and will accelerate.

Nonetheless, Japan has a long way to go to meet international norms. In 2003, Japan's 0.15% of GDP figure for inward FDI put it dead last among 30 OECD countries. Japan's highest year so far in inward FDI was 1999, when it was about twice the 2003 figure. Over the 1999-2003 period, Japan's inward FDI was 0.2% of GDP, about 1/8th the US level. 2004 should be much higher according to initial MOF data.

Going forward, what will be critical is the ability to buy Japanese firms. Globally, as much as 80% of the FDI takes place via purchase of existing firms rather than setting up entirely new "greenfield" facilities. Buying an incumbent firm gives the acquiring firm a workforce, management, suppliers, a customer base, distribution, good will, etc. So far, it has been very hard to buy Japanese firms except for those in such trouble that they need a rescuer. Healthier firms do not sell themselves—to either foreigners or other Japanese. So far, there has not yet been one successful hostile takeover in Japan. We believe that will eventually occur, but we cannot say when.

One obstacle has been the "cross-shareholding" system in which corporate allies own each other's shares and protect each other from takeovers. Firms attempting hostile takeovers have seen the corporate allies circle the wagons.

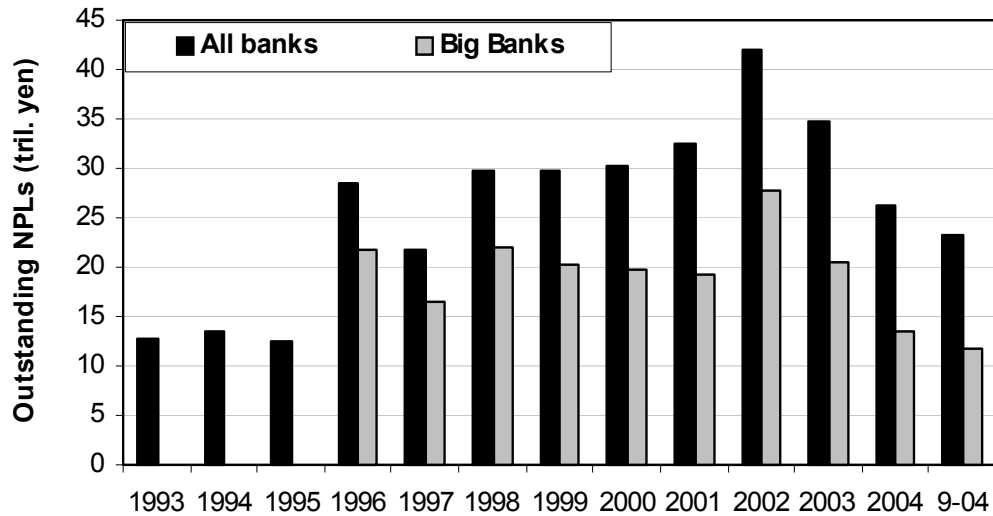
Another obstacle has been the inability to use stock-for-stock swaps in cross-border transactions. The Diet is about to pass a bill lifting this restriction, but implementation is being put off for a year to give Japanese firms time to erect takeover defenses.

The Diet is currently in a rush to pass a number of legal changes that will give firms more legal defenses against hostile takeover, such as poison pills. Up to now, Japanese firms have had few of the legal defenses available to US firms, because the cross-shareholding system made them superfluous. With cross-shareholding being eroded, firms are asking for these legal defenses. They are being sold as a way for firms to protect themselves against foreign takeovers, but they will hinder hostile takeovers by domestic firms as well.

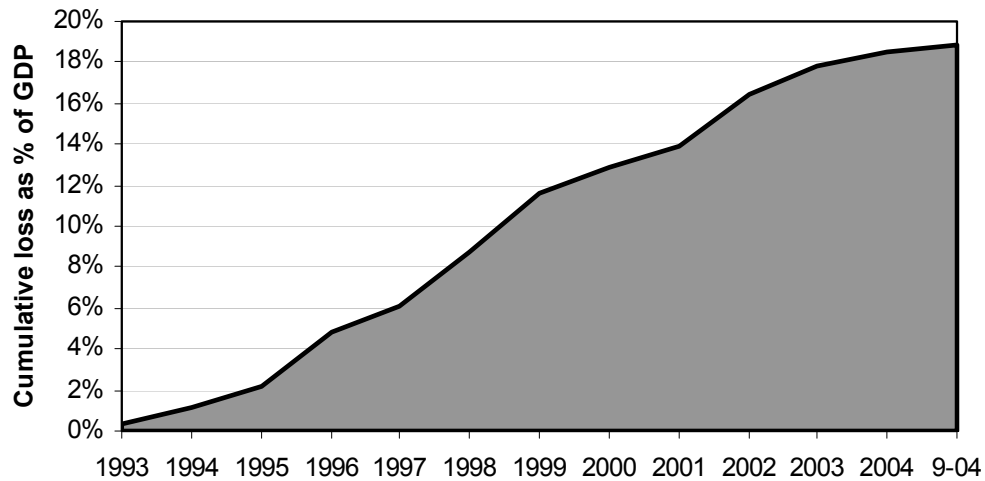
Conclusion

Most of the big economic issues concerning Japan in the next few years will not be focused on bilateral economic ties, but rather Japan's role in the economics and political economy of the Asia-Pacific region. Japan remains America's key ally in Asia, but it lacks the economic wherewithal to play the role that many in the US would like to see it play.

NPLs dropped to lowest level in years. . .



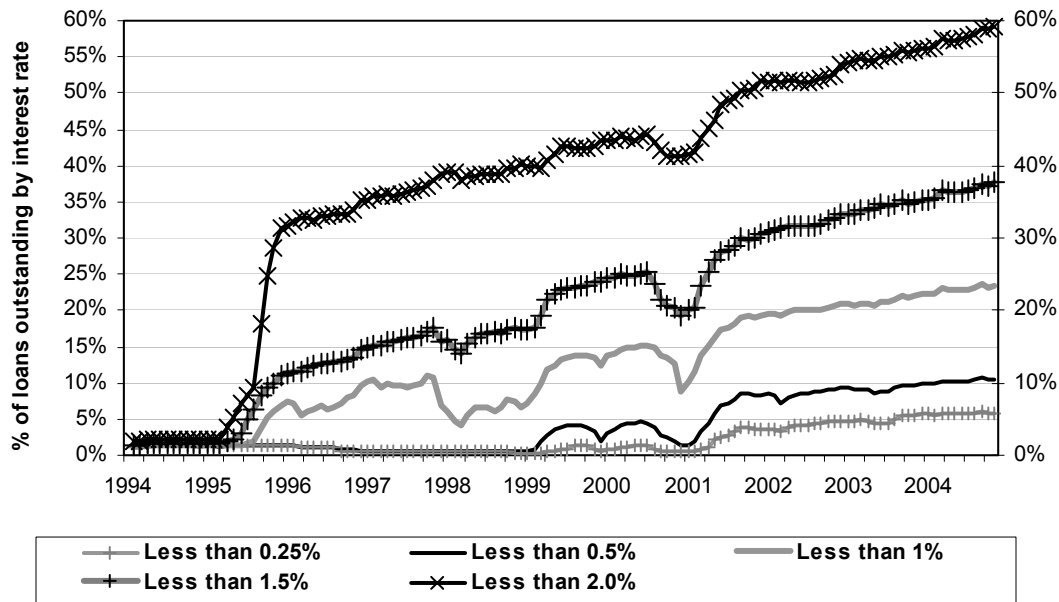
. . . But cumulative cost is nearly 20% of GDP—so far



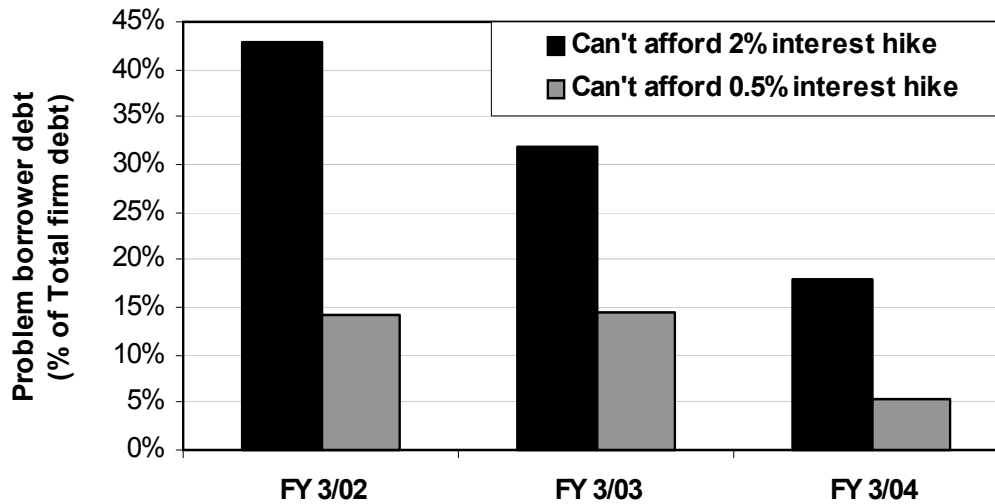
Source: FSA at www.fsa.go.jp/news/news.html

Note: Figures are as of March of the year indicated, except for last column which is Sept. 2004. Cumulative bad debt equals current NPLs plus NPLs written down or written off since fiscal 1992.

Ultra-Low Interest Rates Still Growing As Share of Total

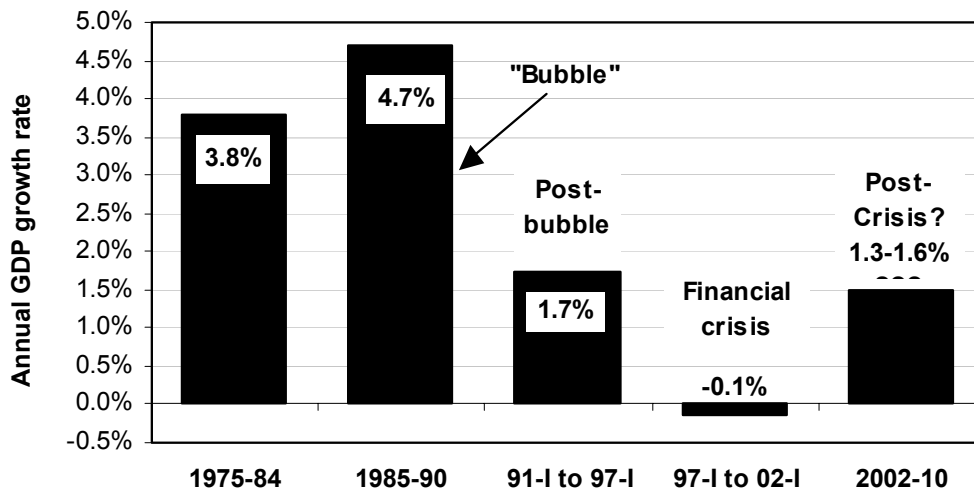


Fewer distressed firms, but still quite a lot

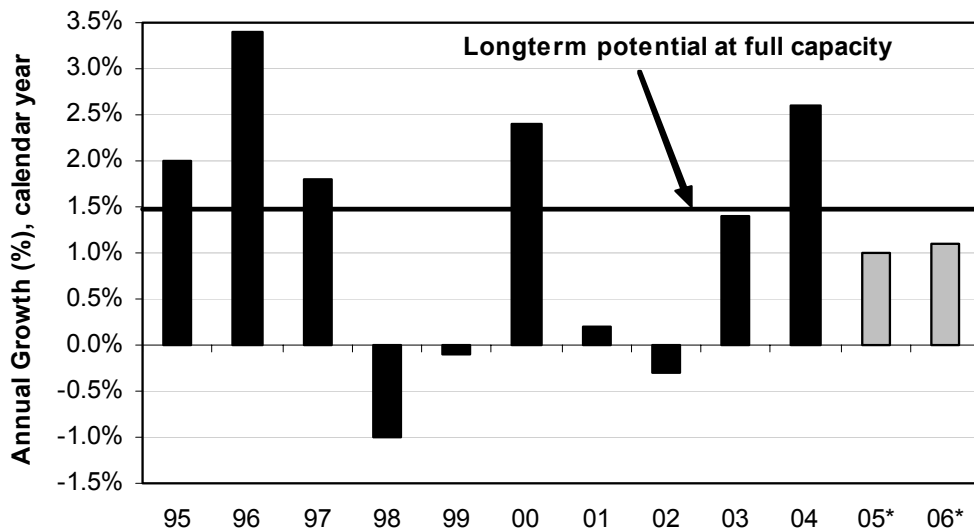


Source: Author calculation based on data from Ned Akov of Macquarie Securities Research (Tokyo) and Bank of Japan. Akov calculated the ratio to total bank lending; we adjusted this to count lending only to companies.

Recovery to what?

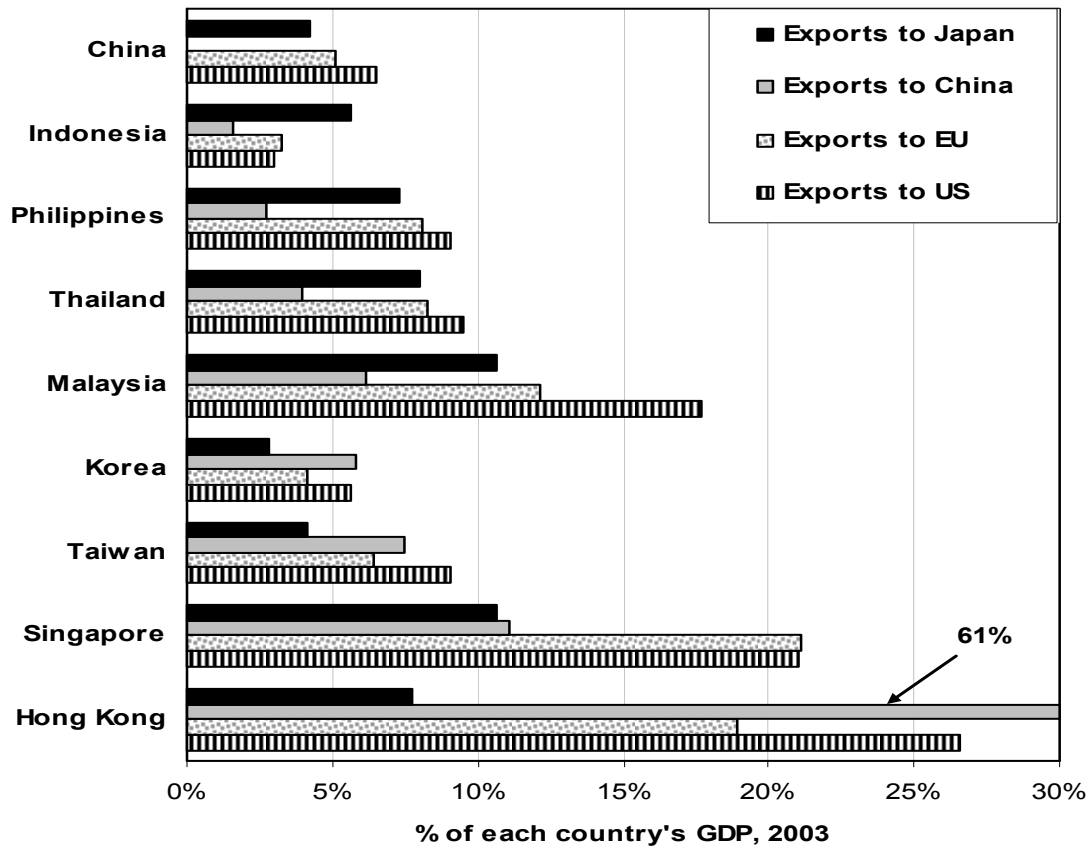


One good year?

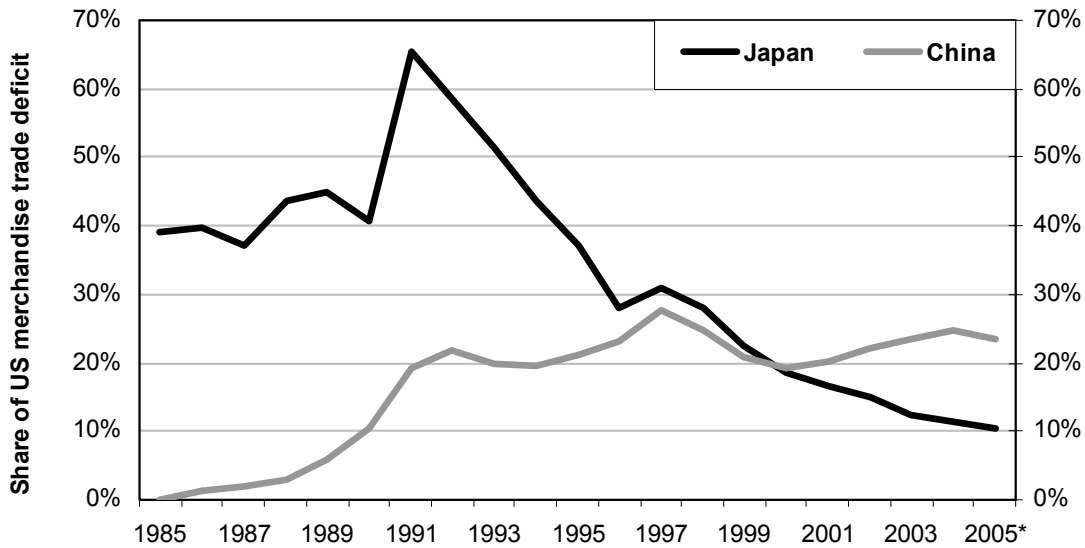


Note: 2005-06 based on a forecast by Peter Morgan of HSBC (Tokyo)

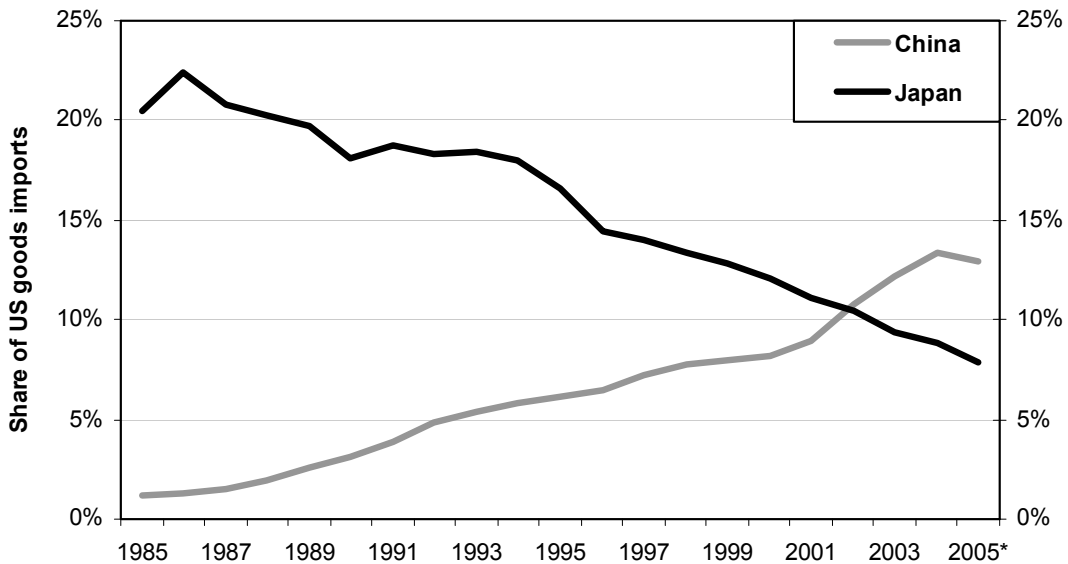
China beats Japan as Asia's customer



Japan's share of US trade deficit falls; China's no higher in 2004 than in 1997

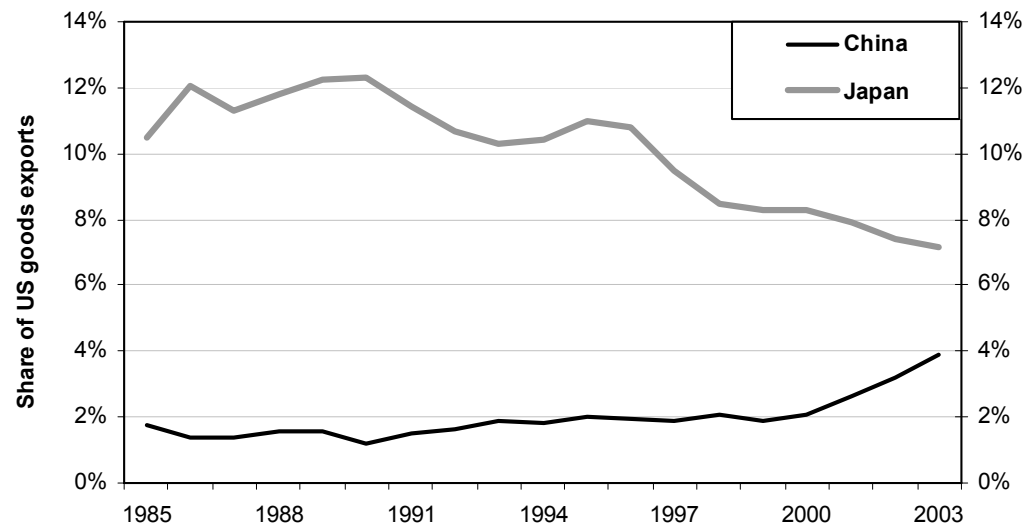


Japan's share of US imports falls; China's share surpasses Japan's

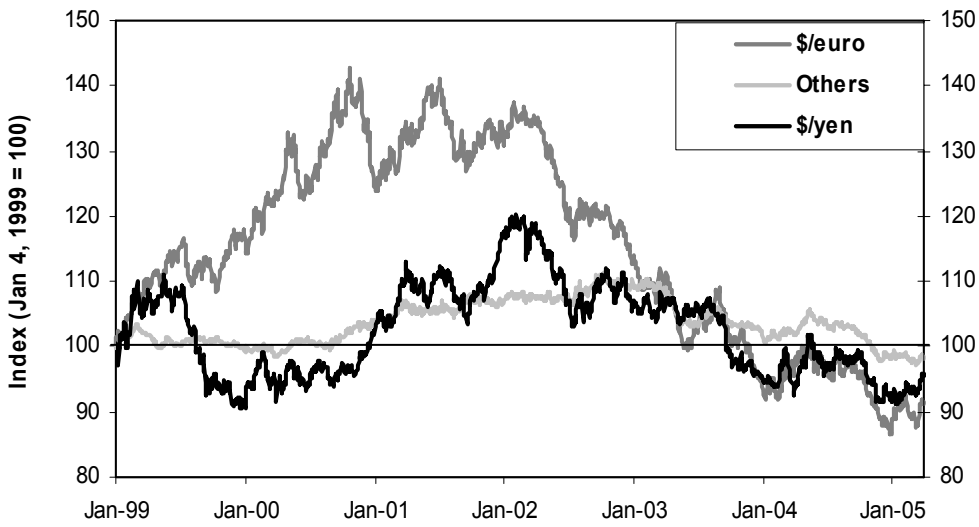


Source: Commerce Dept at <http://www.census.gov/foreign-trade/www/index.html>

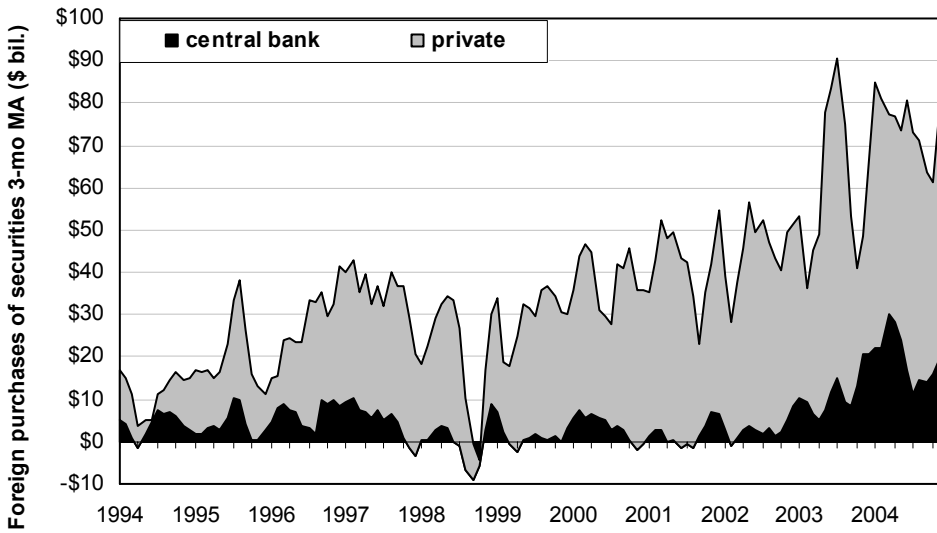
US exports to Japan sink, but China buying more



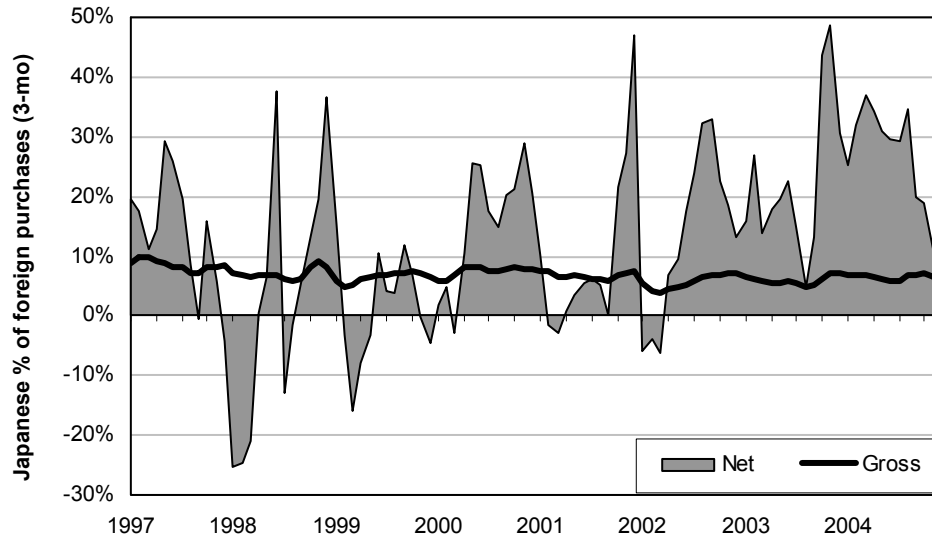
Dollar falls more against Yen and Euro than others



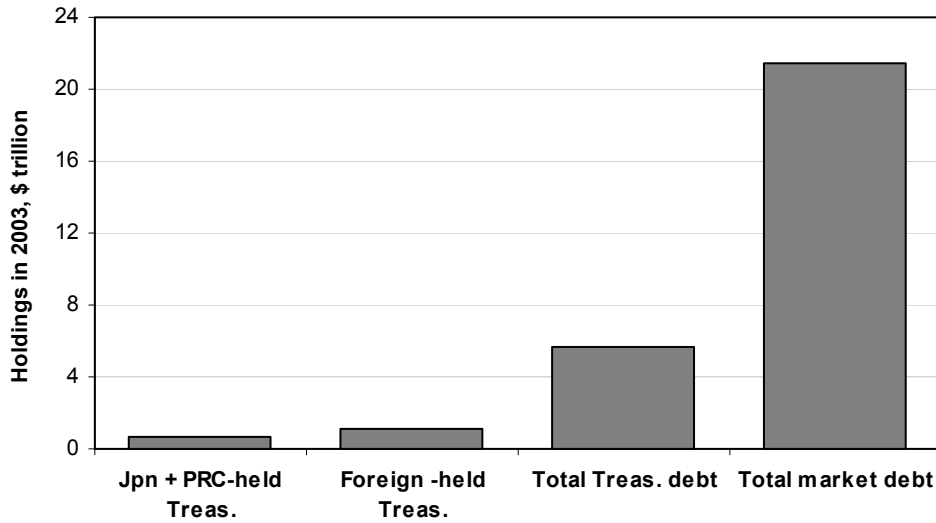
Private investors, not central banks, send most of foreign capital to US



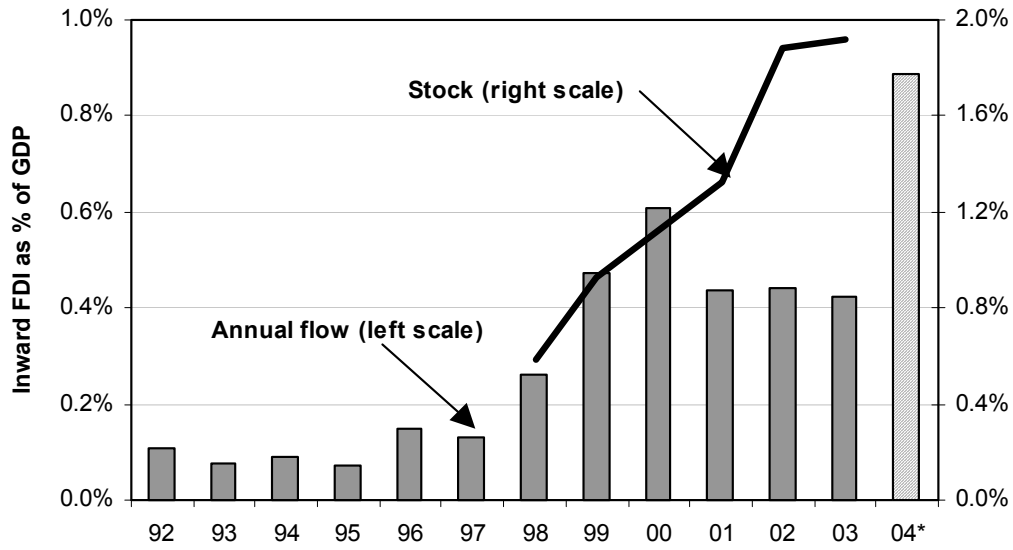
With end of official intervention, Japan accounts for just 10% of net capital inflows to US



China and Japan account for small share of total marketable debt



FDI Rising, But From A Small Base



Source: Ministry of Finance

Finance is the most popular target

